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Foreign Economic Trends and Their Implications for the United States

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KEY ECONOMIC INDICATORS
(In millions of U.S. dollars unless noted)

INCOME AND PRODUCTION	1985	1986	1987
GDP at Current Prices (billions of USD)	4.25	3.67	3.50
Anticipated 1988 GDP in Current Prices	(3.43)		
Per Capita GDP (thousands of USD)	10.3	8.9	8.4
Crude Oil Production (thousand bpd)	42.0	42.0	42.0
Refinery Throughput (thousand bpd)	185.3	245.3	243.2
Electricity Power (millions kwh)	2,636.5	2,891.2	
Population (thousands)	399.5	411.7	416.3
MONEY AND PRICES			
Money Supply (M1)	644.2	624.6	653.8
Quasi Money (M2-M1)	1,749.5	1,721.2	1,912.8
Rate of Deflation (CPI)	-3.0	-1.8	-1.5
Exchange Rate (per USD 1.00)	.377	.377	.377
PUBLIC FINANCE			
Total State Income	1,412	1,240	1,484
Oil Income	994	655	917
Non-Oil Income	418	585	567
Recurrent State Expenditures	912	920	965
Project Expenditures	435	371	482
Total	1,347	1,291	1,447
Government Surplus/Deficit	+65.5	-51.7	+36.0
(Note: Figures for 1987 government revenues are preliminary estimates.)			
BALANCE OF PAYMENTS AND TRADE			
Total Exports (including re-exports)	2,886.4	2,336.0	2,375.5
Petroleum Sector	2,428.0	1,963.1	1,959.4
Imports	3,095.5	2,399.0	2,707.0
Trade Deficit	209.1	63.0	333.5
U.S. Exports to Bahrain	106.9	194.5	204.7
U.S. Imports from Bahrain	90.0	86.9	69.6
U.S. Trade Surplus with Bahrain	16.9	107.6	135.1

Principal U.S. exports: Foodstuffs, aircraft, elevators and winches, boilers, engines, tobacco products, office machinery, industrial machinery, furniture, and chemicals.

Principal U.S. imports: aluminum, petroleum.

Sources: Bahrain Central Statistics Organization: Statistical Abstract for 1986 and 1987; Bahrain Monetary Agency: Annual Report for 1986.

Bahrain's economy shrank by 4.6 percent in 1987, with the gross domestic product (GDP) falling by $170 million while the consumer price index (CPI) registered a reproduction of 1.5 percent. When the final figures for 1988 are in, performance may look better, but not by much.

The Bahraini economy continues to suffer from both fluctuating oil, gas, and petrochemical prices and the negative effect of the tense political and military situation in the Gulf region. Despite brave attempts to continue diversification of its industrial base and reduce its traditional dependence on crude oil and gas production and refining, Bahrian's prosperity is still largely dependent on these sectors. Though the Bahraini Government has tried to control public expenditures, it has not been able to avoid some deficit spending. As in other Gulf states, the public sector has such broad responsibilities that the control of government spending is a tremendously difficult task.

Like other Gulf states, Bahrain experienced sudden and massive economic growth in the 1970s and early 1980s. The island state therefore imported large numbers of foreign skilled and unskilled workers to help build and operate its civil and industrial infrastructure. These workers have tended to stay on in the post-boom period. At the same time, the downturn of recent years has meant the emergence of perceptible unemployment among the native Bahraini work force. According to official statistics the unemployment rate is 3.2 percent, with most of the jobless being young Bahraini men. The further Bahrainization of the labor market is a top government priority, but much remains to be done in this area.

On the brighter side, sophisticated management of the country's dwindling oil reserves has stabilized crude oil production from the onshore Awali field at 42,000 barrels per day (bpd). Bahrain also benefits from the 75,000 bpd it derives from the offshore Abu Sa'fa oil field, which it shares with Saudi Arabia. The island emirate's close proximity to Saudi Arabia's Eastern Providence has helped assure a continued supply of crude oil for the Bahrain Petroleum Company Ltd. (BAPCO) refinery, now slated for modernization. The Bahraini gas liquefaction plant has carved a niche for itself as a producer and exporter of natural gas liquids (NGL). Kuwaiti investors recently revealed plans to restart an iron pelletization plant, the Arab Iron and Steel Company (AISCO). Finally, despite some defections, the island's banking community continues to number an impressive variety of locally registered and offshore banks, plus representative offices. According to the Government of Bahrain, there are 68 offshore banking units (OBU's) in Bahrain. All told, there were 167 banking institutions on the island as of 1987.

PART A: CURRENT ECONOMIC SITUATION AND TRENDS

ECONOMIC RECESSION: Despite the best efforts of Bahrain's government and business community, the economy as measured by gross domestic product declined by 4.6 percent in 1987, with a further decline anticipated for 1988. Measured in current prices, GDP was

$750 million lower in 1987 than in 1985. In addition, prices fell 1.5 percent in 1987, following even larger declines in 1985 and 1986. These negative trends all reflected stagnating commercial activity and downward fluctuating prices on world oil markets. Of course, falling oil prices negatively influenced both national and government income. GDP per capita fell as well; at $8,400 in 1987, it was fully $1,900 lower than in 1985.

THE DOMINANT OIL SECTOR: Despite attempts to continue to diversify the island's economy, the oil and gas sector continues to play a predominant role. In addition to accounting for 55 to 60 percent of government revenues, this sector provides the majority of Bahrain's export revenues. In 1987, Bahrain's crude oil exports were worth $1.68 billion. This was up slightly from 1986, but down dramatically from $2 billion in 1985. Crude oil export revenues are largely counterbalanced by the cost of crude oil imports, most of which are used to feed Bahrain's refinery. In 1987, crude oil imports cost Bahrain $1.25 billion, putting net income on the crude oil account at about $430 million. Sophisticated use of gas reinjection by the Bahrain National Oil Company (BANACO) has helped stabilize crude oil production from the island's Awali field at 42,000 bpd. In addition, Bahrain gets 75,000 bpd from the Abu Sa'fa field it shares with neighboring Saudi Arabia. Though the days of the aged Awali field, even with excellent management, are clearly numbered, Bahrain should be able to count on Abu Sa'fa oil for a long time to come. As Bahrain's total oil production of about 117,000 bpd is far too small to allow the island emirate to influence world oil prices, it has little choice but to maximize its output and hope for the best in terms of prices.

REFINING: In addition to producing crude oil from the Awali and Abu Sa'fa fields, Bahrain also produces significant amounts of refined products. It possesses one of the oldest refineries in the Gulf -- in operation since 1932. The refinery is owned and managed by BAPCO, a joint stock company owned 60 percent by BANACO and 40 percent by Caltex Bahrain, a subsidiary of the American oil company. The refinery had an average output of 243,000 barrels daily in 1987, according to the latest government statistics. Approximately 195,000 bpd consisted of Arabian light crude oil imported from Saudi Arabia's Eastern Province, while the remainder came largely from Bahrain's own Awali field. The refinery, with an output spanning a broad range of refined products, is known in industry circles for its production flexibility.

MODERNIZATION PLANS: Bahraini oil industry officials appear to believe that the refinery could be rendered more efficient by changing its production facilities to produce less heavy fuel-oil and more in the way of lighter products. A $500 million modernization project, due to start this year, should help boost the profitability of Bahrain's exports of refined products.

INDUSTRIAL DIVERSIFICATION: Despite the tough times, Bahrain is doggedly continuing to diversify its industrial sector. An iron pelletization facility known as the Arab Iron and Steel Company (AISCO) opened in 1984. Despite its strategic location in the middle of the Gulf, as well as a capacity of 4 million tons per year, AISCO has had to struggle to survive without access to Iranian and Iraqi markets. However, the plant was recently purchased by Kuwaiti investors and is scheduled for reopening in 1989. Its rebirth is an optimistic sign reflecting investors' hopes for a durable peace between Iraq and Iran. ALBA, the local aluminum smelter, whose construction was predicated on a large export market in the Gulf, has also suffered from the recession of recent years. Nevertheless, high aluminum prices have helped the enterprise recently; an expansion is now being planned, reflecting hopes of growing market opportunities. The local venture into production of petrochemicals, the Gulf Petrochemical Industries Corporation (GPIC), has encountered trouble in developing an adequate revenue base. It appears likely, however, that the facility will continue operating at least in the medium term, since it has found a market for its ammonia and methanol in the Far East and India. In addition, the local Arab Shipbuilding and Repair Yard (ASRY) is planning to add a new drydock to its facilities in the near future.

NEW INDUSTRIAL DEVELOPMENT ZONE: Bahrain's Ministry of Development and Industry has recently opened an office for industrial development charged with attracting new foreign investment projects to the manufacturing sector. The cornerstone of the new office's strategy is the development of a subsidized industrial zone. Covering 3 million square meters in the northeast corner of Bahrain's main island, the new zone is intended to serve as a magnet for foreign investors. Bahraini authorities are betting that war-weary combatants in the Gulf will be hungry for industrial goods with the return of peace. They would like to see foreign capital assist in making Bahrain a manufacturing center, thereby complementing the island emirate's established role as a center for transshipment and finance.

THE FINANCIAL SECTOR: The most successful sector of the economy, aside from oil and gas, is clearly the financial industry. Bahrain has effectively used its traditional status as a regional transit point and communications center to attract offshore banking units, investment houses, and representative offices. According to official statistics, there were 170 financial institutions in Bahrain in 1987, of which 15 were American. A breakdown of Bahrain's banking sector includes 19 commercial banks, 2 specialized banks, 67 offshore banking units, 18 investment banks, 58 representative banks, and 6 brokers' offices.

Bahrain's financial institutions have attracted funds from all over the Gulf, thanks to the island's liberal banking regulations. Unlike the situation in neighboring Saudi Arabia, there is no

serious Islamic-sensitivity to the use of interest in banking operations in Bahrain. The presence of a large banking community has also made it significantly easier for the Government of Bahrain to finance its deficits through the sale of treasury bills (T-bills) and development bonds. By offering attractive yields and maturities, the government has assured strong interest in its T-bills and bonds from local banks. The Bahrain Monetary Agency recently decided to allow offshore banking units to purchase the bills as well.

In addition to banks, the Bahrain financial sector includes a sizable number of insurance companies. As of 1987, there were 35 insurance companies operating in Bahrain; they included 6 local firms, 13 foreign insurance companies with local branches, and 16 exempt (offshore) companies offering insurance services. As defined by Bahraini law, exempt companies are firms that have their main offices in Bahrain but operate exclusively outside the country. They are therefore exempt from the provision of the commercial code requiring a 51-percent Bahraini equity share in each locally incorporated company.

FISCAL POLICY: The government budget for 1988 is estimated to be $1.14 billion. According to official statements, expenditures are expected to exceed revenues by $159.2 million, and the entirety of the deficit is to be covered by domestic borrowing. In fact, given the government's dependence on the oil sector for 55-to-60 percent of its revenues, the recent downward trend in oil prices could well increase the deficit substantially. Budget deficits have become an increasingly serious problem for the government since 1986, when the red ink flowed to the tune of $51.7 million. The government follows a policy of limiting the creation of foreign debt as much as possible and relying on domestic borrowing instead. Thus, it has turned successfully to issuing a 91-day T-bill to meet its financial needs. T-bill sales in Bahrain are held weekly; the volume of the sale has gradually risen to reach the rate of $15.4 million. Until recently, only local banks could buy the bills; however, the government has now decided to cast its net wider in the search for financing and permit all offshore banking units to buy them as well. This development may well indicate that larger government deficits are anticipated for the future. Sales of T-bills are generally oversubscribed, since their short maturity and competitive yields make them attractive to investors. In addition to bills of the Treasury, the government issues longer-term development bonds in smaller volumes.

The government budget currently represents about 12.5 percent of GDP. Were the deficit to remain at around $159 million, it would represent no more than 2 percent of GDP. Even a doubling of the deficit to $320 million would bring it only to about 4 percent of GDP -- quite manageable for a limited period of time. Therefore, the deficit problem is less acute than that faced by many other nations, including the United States. However, heavy reliance on oil for official revenues means that the government could face more

serious problems were oil prices to drop drastically. According to the 1988 budget, the oil sector was originally expected to earn 58.6 percent of total revenue. Specifically, total revenue anticipated for the 1988 budget amounts to $1.14 billion, with revenue from oil totaling $667.8 million. Within the oil sector, $219.6 million would come from the sale of Awali oil, $359.2 million from the sale of Abu Sa'fa oil, and $78.8 million from the sale of natural gas.

FOREIGN TRADE: Long open to the outside world, Bahrain is a country with a tradition of foreign trade. According to government statistics, in 1987 the volume of Bahrain's foreign trade exchanges totaled $5.1 billion, or $12,439 per capita. On the export side, the picture is still dominated by oil, gas, and related products. Of $2.4 billion in total exports in 1987, $2 billion fell into the petroleum category, broadly defined to include all hydrocarbon exports. Bahrain's overall merchandise trade was in deficit between 1985 and 1987. The trade deficit dropped sharply from $209.1 million in 1985 to $63 millon in 1986, but rose in 1987 to $331.5 million. This took place despite relatively successful efforts to control imports, as the value of petroleum and gas-related exports plummeted and oil markets weakened around the world. Bahrain's export earnings from oil and gas totaled $2.4 billion in 1985; by 1987, earnings had dropped to $468.8 million.

The United States has enjoyed a surplus in its bilateral trade with Bahrain in recent years. Most local observers credit the fall in the value of the dollar for the return of U.S. product competitiveness in the Bahraini marketplace. From $16.9 million in 1985, the U.S. trade surplus vis-a-vis Bahrain leapt to $135.1 million in 1987. That year, bilateral merchandise trade between the United States and Bahrian totaled $274.3 million. American business has done increasingly well in the Bahraini market against their major Western and Japanese competitors. According to officials government statistics, the United States led the list of Bahrain's major trading partners in 1987, accounting for 19.2 percent of its non-oil imports. The United Kingdom was second with 18.3 percent, while Japan placed third with 10.5 percent. Back in 1985, by way of contrast, the United States supplied only a 13.7 percent share of Bahrain's non-oil purchases and ran second to Japan, which took an 18.4 percent share.

Bahrain's import ledger is dominated by fuels, lubricants, and other petroleum-related goods. In 1987, these goods accounted for 47 percent of the value of Bahrain's imports. This predominance reflects the fact that Bahrain imports the lion's share of the 250,000 bpd of crude oil refined at the Bahrain Petroleum Company (BAPCO) refinery at Sitra island. Machinery and transportation equipment come next, accounting for about 22 percent of imports by value in 1987. Food imports accounted for only 7.3 percent of the 1987 import bill, reflecting Bahrain's advanced level of economic development.

POPULATION AND LABOR FORCE: According to official statistics, Bahrain was home to some 416,000 people in 1987. This figure includes both Bahraini citizens and expatriate workers, many of whom resided in Bahrain for considerable periods. Rather than being a precise head count, it is a statistical projection based on the actual census figures from 1981. Of the total, 137,794 were expatriates, most of these being workers. Population growth in Bahrain is rapid; between 1981 and 1987, for example, total population rose by approximately 65,000, or 18.6 percent.

According to Bahriani statistics, expatriate workers dominate the labor force in numerical terms. In 1986, out of a total work force estimated at 172,000, they accounted for 101,000, or 58.7 percent. Expatriates are found all along the employment spectrum, from menial, unskilled labor to professionals. The expatriate population contains large numbers of Indians, Pakistanis, Sri Lankans, and Filipinos. The presence of expatriatrs has been crucial to the economic development of Bahrain in the last decade. Understandably, the government is officially committed to increasing the Bahraini share of the work force. This policy, known as Bahrainization, is essential for reducing unemployment, now estimated at 3.2 percent among Bahrainis.

Because of the island's universal education policy and excellent system of public schools, the native Bahraini work force is well-educated and possesses a high degree of fluency in English. Because of its long history as a center of commerce and industry, Bahrian's work force has a well-established "work ethic," perhaps differentiating in this respect from other countries in the region.

PART B: IMPLICATIONS FOR THE UNITED STATES

UNCERTAIN OIL SECTOR INCOME: Given the recent volatility in world energy markets, Bahrain's oil and gas sector faces uncertain prospects, at least in the short term. A continuing oil glut will hold the petroleum sector's income down, while a real price war will send it plummeting. Bahrain is too small a producer to influence oil prices. Without substantial industrial diversification and a lessening of dependence on the energy sector, Bahrain's prospects for economic growth will be limited at best. The government clearly realizes this and seeks to attract foreign investment for just this reason. Because of the long-established economic ties between the United States and Bahrain, American investors would be welcome to contribute to the diversification effort.

DEPENDENCE ON POLITICAL SITUATION: As is true in so much of the Middle East, prosperity in Bahrain remains hostage to the political and security situation in the wider Gulf region. If Bahrian's plans to build up its industrial base outside the oil sector are to see fruition, there must be peace and stability in the region. Otherwise, the export markets these new industries require will not

materialize. Assuming that the recent outbreak of peace lasts, the chances are good that Bahrain will be able to augment its role as a regional financial center by further developing such industries as aluminum smelting and processing, iron ore pelletization, petrochemical production, and petroleum refining. The development of tourism is also receiving a good deal of attention. The country's sunny weather, good hotel facilities, and fortunate geographic location make it attractive from the point of view of both business and vacation tourism. Given a stable regional political environment, U.S. investors could find in this island emirate both profitable export opportunities and a potentially lucrative field for industrial investment.

POTENTIAL PROFITS: Conceivably, U.S. exporters could find a small but lively market for industrial equipment, consumer goods, and consumer durables such as automobiles in Bahrain. In the event of political stability, investors could use the island as a base for approaching far larger markets in the region. Of course, U.S. firms will continue to face stiff competition from experienced Japanese and European firms in Bahrain.

INHERENT ADVANTAGES: Viewed objectively, Bahrain has much to offer American businesspeople and investors interested in the Gulf region. In addition to a literate, well-trained work force of both expatriates and local workers, Bahrain offers highly developed transportation and communication facilities to potential investors. The presence of numerous banks and insurance companies is also a distinct plus. Laws regarding repatriation of profits are liberal; duties and tariffs are relatively low; and taxes are almost absent by Western standards. Unlike other Middle Eastern countries, religious sentiment and business do not collide or conflict with each other, even on the sensitive question of banking interest. Finally, the government and local business community are very open to foreign investment, to state the case mildly. The potential for American business to benefit from these favorable conditions is considerable.

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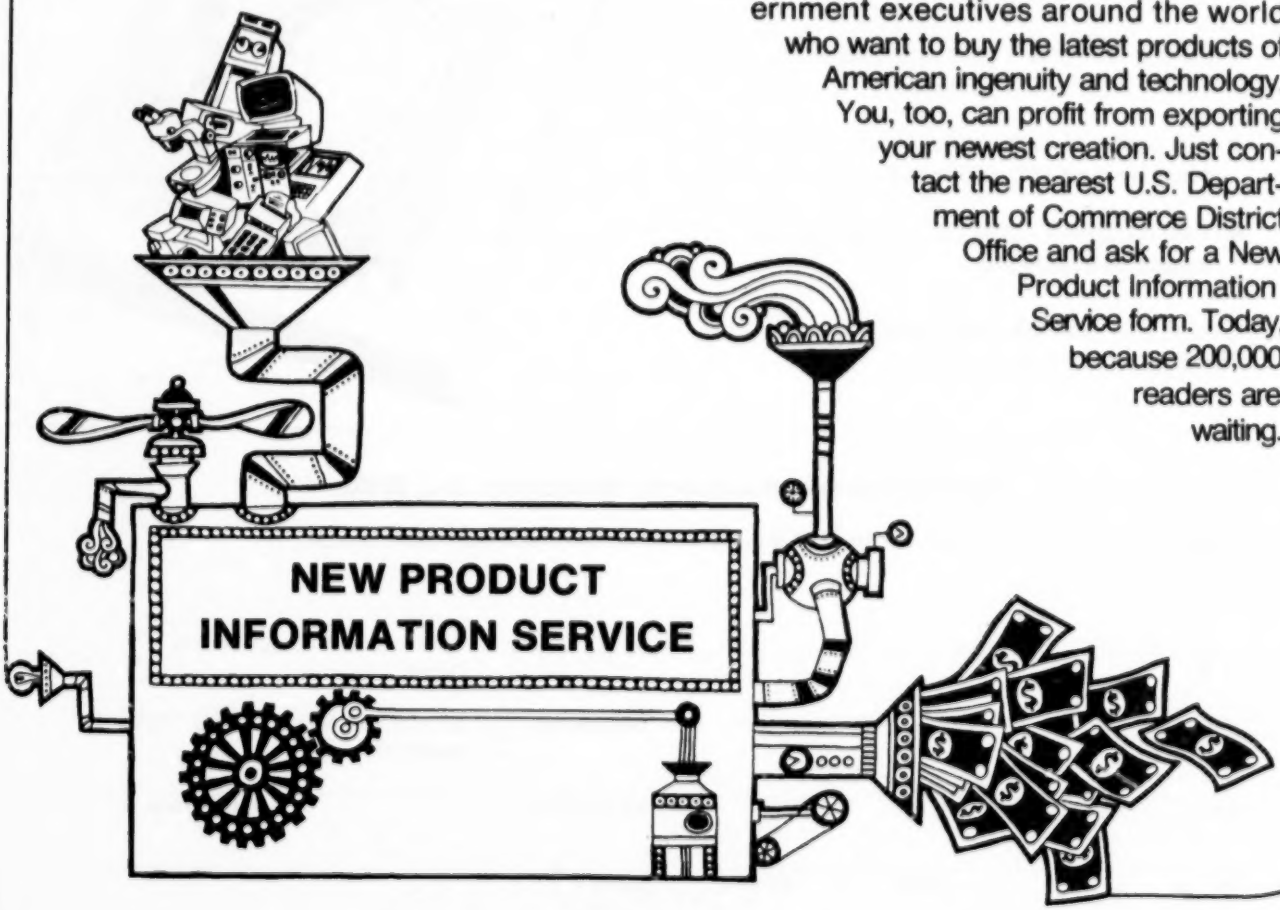

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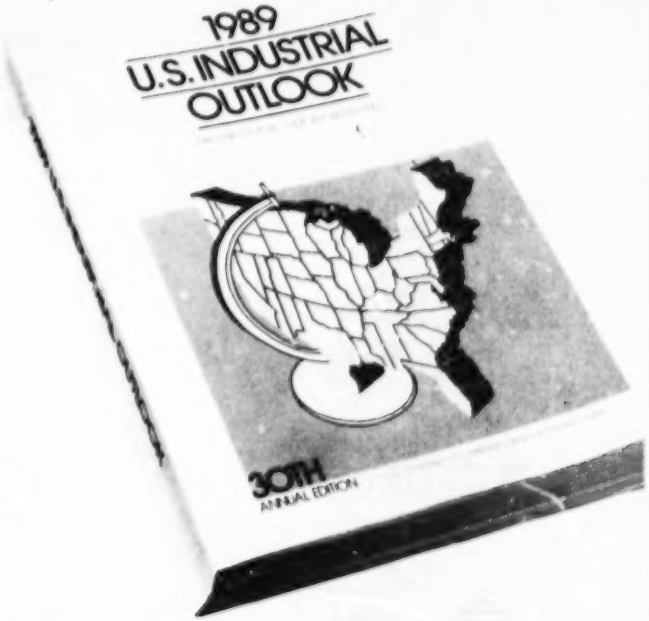

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